

In the United States Court of Appeals
for the Ninth Circuit

UNDERWRITERS SERVICE, INC., a Corporation,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decision of the Tax Court
of the United States

BRIEF FOR THE RESPONDENT

CHARLES K. RICE,
Assistant Attorney General.

LEE A. JACKSON,
I. HENRY KUTZ,
DAVID O. WALTER,
Attorneys,
Department of Justice,
Washington 25, D. C.

FILED

APR 19 1958



INDEX

	Page
Opinion below	1
Jurisdiction	1
Question presented	2
Statutes and Regulations involved.....	2
Statement	2
Summary of argument.....	5
Argument:	
I. Taxpayer's contention is contrary to the intent and purpose of the statutory pro- vision	6
II. The language of Section 435(d) of the In- ternal Revenue Code of 1939 does not warrant the construction, for which tax- payer contends, and which would result in the use of an exaggerated and grossly artificial income for the base period year 1946	13
III. Alternatively, if this Court disagrees with the Tax Court, the case should be re- manded for computation of the excess profits credit by the method proposed in the amended answer.....	19
Conclusion	21
Appendix	22

CITATIONS

Cases:

<i>Cabell v. Markham</i> , 148 F. 2d 737, affirmed, 326 U. S. 404.....	17
<i>Crooks v. Harrelson</i> , 282 U. S. 55.....	17
<i>Federal Deposit Corp. v. Tremaine</i> , 133 F. 2d 827	16
<i>Holy Trinity Church v. United States</i> , 143 U. S. 457	17
<i>Johnson v. United States</i> , 163 Fed. 30.....	16
<i>Lewyt Corp. v. Commissioner</i> , 349 U. S. 237.....	17
<i>Underwriters Service Inc. v. Commissioner</i> , 28 T.C. 364	1
<i>United States v. Am. Trucking Ass'ns</i> , 310 U. S. 534	17

Statutes:	Page
Internal Revenue Code of 1939:	
Sec. 434 (26 U.S.C. 1952 ed., Sec. 434)	22
Sec. 435 (26 U.S.C. 1952 ed., Sec. 435)	9, 22
Secs. 445-447 (26 U.S.C. 1952 ed., Secs. 445-447)	7
Sec. 450 (26 U.S.C. 1952 ed., Sec. 450)	7
Sec. 453 (26 U.S.C. 1952 ed., Sec. 453)	7
Sec. 459 (26 U.S.C. 1952 ed., Sec. 459)	7
Secs. 461-464 (26 U.S.C. 1952 ed., Secs. 461-464)	7
Sec. 474 (26 U.S.C. 1952 ed., Sec. 474)	7
Revenue Act of 1951, c. 521, 65 Stat. 452, Sec. 602	7
Miscellaneous:	
H. Rep. No. 3142, 81st Cong., 2d Sess. pp. 5, 14 (1951-1 Cum. Bull. 187, 190, 196)	8, 9
S. Rep. No. 2679, 81st Cong., 2d Sess., pp. 5-6, 15 (1951-1 Cum. Bull. 240, 243, 250)	9
Prentice-Hall, Federal Excess Profits Tax (1954), Pars. 45,439-45,441, pp. 45,445-45,450	14
Treasury Regulations 130, Sec. 40.435-1	24

**In the United States Court of Appeals
for the Ninth Circuit**

No. 15,787

**UNDERWRITERS SERVICE, INC., a Corporation,
PETITIONER**

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

**On Petition for Review of the Decision of the Tax Court
of the United States**

BRIEF FOR THE RESPONDENT

OPINION BELOW

The opinion of the Tax Court (R. 32-37) is reported at 28 T. C. 364.

JURISDICTION

This petition for review (R. 39-44) involves federal income and excess profits taxes for the years 1950, 1951 and 1952. On September 28, 1954, the Commissioner mailed to the taxpayer notice of a deficiency in the total amount of \$17,923.79. (R. 9-11.) Within ninety days thereafter and on December 22, 1954, the taxpayer filed a petition with the Tax Court for a redetermination of that deficiency

under the provisions of Section 6213 of the Internal Revenue Code of 1954. (R. 6-9.) The decision of the Tax Court was entered on May 17, 1957. (R. 38.) The case is brought to this Court by a petition for review filed August 14, 1957. (R. 39-44.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Whether, in computing its excess profits credit, under Section 435 of the Internal Revenue Code of 1939, taxpayer may attribute to the twelve months of the base period year, 1946, more than \$85,000 of non-existent income, by attributing two incomes to the month of September and to the month of December, and by increasing the actual income of each of the other months of the year.

STATUTES AND REGULATIONS INVOLVED

These may be found in the Appendix, *infra*.

STATEMENT

The Tax Court found the facts as stipulated. (R. 24-29, 33.) They may be summarized as follows:

Taxpayer is a California corporation incorporated on May 19, 1937. (R. 24.) On September 20, 1946, it became a wholly owned subsidiary of Henry J. Kaiser Company and continued as such until December 18, 1946, on which day Henry J. Kaiser Company ceased to own 95 per cent of taxpayer's voting stock. (R. 25.)

Henry J. Kaiser Company was the common parent of an affiliated group of corporations which filed a

consolidated return for the taxable year of the common parent which ended June 30, 1947. Taxpayer's income for the period it was a wholly owned subsidiary, i.e., September 21, 1946, through December 18, 1946, was included in the consolidated return of the affiliated group of corporations. (R. 25.) In a letter to the Commissioner dated April 10, 1947, taxpayer asked for a ruling as to the proper method of reporting its income for the portion of 1946 during which it was not a member of the affiliated group, stating that it desired to maintain its calendar year basis for reporting income and was concerned as to whether it would be required to adopt the fiscal year period of Kaiser. (R. 26, 27-29, 33-34.) Taxpayer was advised that it would not be required to change its accounting period to conform to that of Kaiser unless it was filing a consolidated return with Kaiser for the next year. The Commissioner also advised that taxpayer would be required to file a separate return for each period during 1946 when it was not a member of the affiliated group. (R. 17-20, 34.) Taxpayer filed separate returns for the periods January 1, 1946, to September 20, 1946, and December 19, 1946, to December 31, 1946. (R. 26, 34.)

Taxpayer's excess profits net income for the periods indicated was as follows (R. 26-27, 34):

January 1 to September 20, 1946.....	\$68,174.60
September 21 to December 18, 1946....	78,512.90
December 19 to December 31, 1946.....	(7,131.61)

Taxpayer filed and was allowed a claim for a refund of a portion of the income taxes paid by it for the January 1 to September 20 period, based upon a carry-

back of the December 19 to December 31 operating loss of \$7,131.61. (R. 26, 34.)

Taxpayer's books were not closed to reflect income for any of those fractional periods. They were closed only once for the entire year 1946, showing a profit of \$139,791.09, which was credited to surplus. (R. 27, 34-35.)

The sum of \$139,791.09, minus a statutory loss adjustment of \$3.33, or \$139,787.76, was determined by the Commissioner in his notice of deficiency to be taxpayer's excess profits net income for the twelve months of 1946. (R. 13, 35.) Using this amount plus amounts, here undisputed, for other months of the base period years, the Commissioner determined deficiencies in excess profits tax liabilities for the taxable years as follows (R. 25, 32) :

1950	-----	\$1,043.52
1951	-----	9,791.02
1952	-----	7,089.25

As taxpayer's brief states (p. 9), there is no dispute as to taxpayer's excess profits net income for the years 1947 through 1949, nor is there any dispute with respect to the amount for 1946 if the Commissioner's theory, upon which his computation is based, is correct.

Taxpayer contends that its total excess profits net income for the 12 months of the year 1946 is \$226,590.62. (R. 30-31, Br. 7.) The Tax Court sustained the Commissioner.

SUMMARY OF ARGUMENT

The Korean War excess profits tax was designed to tax a portion of the excessive or unusual profits of the wartime boom years. The amount of excessive profits is determined, under the method applicable here, by a comparison of a taxpayer's income during the taxable years, 1950 to 1952, with its income during the base period years, 1946 to 1949. The income for the earlier years, with certain adjustments, forms the basis for the excess profits credit to be applied in the later taxable years.

At issue here is taxpayer's contention that under the terms of the statute it is entitled, in computing its credit for the years 1950 to 1952, to attribute to the twelve months of the base period year, 1946, more than \$85,000 of non-existent income.

This contention is directly contrary to the purpose and intent of the statute, and to the entire system for determining the excess profits credit. Taxpayer does not, indeed, dispute this, but relies on its reading of the literal language of the statute.

That language, however, far from leading clearly and inevitably to the absurd result which taxpayer claims, is, as the court below pointed out, completely inapplicable to taxpayer's situation. The specific sentence of Section 435(d) of the Internal Revenue Code of 1939 on which taxpayer relies, not only is not intended to apply, but its literal language shows that it does not authorize a computation of the income for a month as if that full month fell within two taxable years.

Alternatively, the Commissioner argued that a literal reading of the statute, applying the statutory

definition of "Taxable year," would result in an excess profits net income of zero for the months during which taxpayer formed a part of the affiliated group for which a consolidated return was filed. Accordingly, if the language of the statute is to be construed in disregard of its purposes, taxpayer's excess profits credit is even less than that forming the basis of the deficiency notices. The Tax Court rejected both taxpayer's argument on the main, and, necessarily, the Commissioner's argument on this alternative. If this Court should disagree with the Tax Court, the case should be remanded for a redetermination on the basis of the alternative.

ARGUMENT

I

Taxpayer's Contention Is Contrary To The Intent And Purpose Of The Statutory Provision

The excess profits tax is designed to siphon off a portion of the unusual or excessive profits made by corporations in wartime booms, in this case the Korean War, regardless of whether the profits are directly related to war production. The tax is imposed upon the adjusted excess profits net income. This is derived from the excess profits net income, which in turn is derived from the normal tax net income, with certain adjustments. From the excess profits net income is subtracted the taxpayer's excess profits credit, to arrive at the adjusted excess profits net income. In dispute here is the amount of the credit to which taxpayer is entitled.

In general a corporation may choose whichever of two methods of computing the credit will give it the

greater credit. One method is based on taxpayer's income during the base period years 1946-1949; the other allows as a credit designated rates of return on the corporation's invested capital. It is the former method which is being used here.

Under Section 435(a) of the Internal Revenue Code of 1939 (*infra*) the excess profits credit is the sum of 85 per cent of the average base period income plus adjustments for additions to capital or reductions therein (not here involved). For use in 1951 and 1952 this percentage was reduced to 84 per cent and 83 per cent respectively (R. 13; Section 602 of the Revenue Act of 1951, c. 521, 65 Stat. 452). The base period is the years 1946 through 1949. In general¹ the average base period net income is determined by computing the excess profits net income for each month in the base period, eliminating the poorest consecutive twelve months, and dividing the aggregate of the other 36 months by three.

In determining the excess profits net income for the base period years the statute permits numerous adjustments for abnormalities, nonperiodic income, and other items which if included would distort those years as a norm. It also contains provisions for the situation where the taxpayer corporation was not in existence during any or all of those years, or has acquired corporations which were separate entities during those years. (Sections 445-447, 461-464, 474.) It also contains special relief provisions for particular industries. (Sections 450, 453, and 459.) None of

¹ This is a very general description intended merely to introduce the main outline. The following discussion of the detailed provisions will show some qualifications.

those complications are, however, involved in the present case.

The general purpose and intent of Section 435 is clear. As set out in the House Committee Report (H. Rep. No. 3142, 81st Cong., 2d Sess., p. 5 (1951-1 Cum. Bull. 187, 190)):

For taxpayers on a calendar-year basis the base period under the bill is the 4-year interval 1946 to 1949. As a general rule taxpayers are permitted to eliminate one of the base-period years. The normal tax net income of the remaining years is then adjusted in a manner described below and averaged. The resulting average base period net income is then reduced by 15 percent for the purposes of the credit.

Under the World War II law the base period was 1936 to 1939, and the credit was 95 percent of the average earnings in this period. It was necessary to substitute the period 1946 to 1949 for the 1936 to 1939 base in this bill both because of the large number of businesses which have been started recently and because of the substantial changes which have occurred in the businesses in existence between 1936 and 1939. The period 1946 to 1949 is the only recent 4-year, nonwar period available. However, it is a period of unusual business prosperity which to a substantial degree was built on the deferred demands, the accumulated savings of World War II, and large postwar defense expenditures. Since this unprecedented level of business activity could hardly have been expected to continue permanently, the use of the income of the years 1946 through 1949, without adjustment, would produce a general overstatement of the taxpayers' earning capacity in the absence of hostilities in

Korea or a large program of military expenditures. For this reason your committee believes that a 15-percent cut-back in average base period income is a moderate adjustment.

To the same effect see S. Rep. No. 2679, 81st Cong., 2d Sess., pp. 5-6 (1951-1 Cum. Bull. 240, 243).

H. Rep. No. 3142 also stated (p. 14) (1951-1 Cum. Bull., p. 196) :

The equitable calculation of excess profits by a comparison between a base-period experience and the income of the taxable year requires the removal of abnormalities not only from the income of the taxable year but from the income of the base period as well.

And see S. Rep. No. 2679, p. 15 (1951-1 Cum. Bull. 250).

For convenience at this point we quote the relevant provisions of Section 435, with the provisions here in dispute italicized.

SEC. 435 [as added by Sec. 101, Excess Profits Tax Act of 1950, c. 1199, 64 Stat. 1137]. *EXCESS PROFITS CREDIT—BASED ON INCOME.*

(a) [as amended by Sec. 602, Revenue Act of 1951, c. 521, 65 Stat. 452] *Amount of Excess Profits Credit.*—The excess profits credit for any taxable year, computed under this section, shall be—

(1) *Domestic corporations.*—In the case of a domestic corporation the sum of—

(A) 83 per centum of the average period net income.

(B) if the average base period net income of the taxpayer is the amount determined under subsection (d) of this

section or under section 442, 12 per centum of the amount of the base period capital addition, computed under subsection (f), and

(C) 12 per centum of the net capital addition (as defined in subsection (g) (1)) for the taxable year,

minus 12 per centum of the net capital reduction (as defined in subsection (g) (2)) for the taxable year.

* * * *

(b) *Base Period*.—As used in this subchapter the term “base period” means the period beginning January 1, 1946, and ending December 31, 1949, except that in the case of a taxpayer whose first taxable year under this subchapter was preceded by a taxable year which ended after December 31, 1949, and before April 1, 1950, and which began before January 1, 1950, the term “base period” means the period of 48 consecutive months ending with the close of such preceding taxable year.

* * * *

(d) *Average Base Period Net Income—General Average*.—The average base period net income determined under this subsection shall be determined as follows:

(1) *By computing the excess profits net income for each month in the base period. The excess profits net income for any month during any part of which the taxpayer was in existence shall be the excess profits net income for the taxable year in which such month falls divided by the number of full calendar months in such year, but in no case shall the excess profits net income for any*

month be less than zero. The excess profits net income for any month during no part of which the taxpayer was in existence shall be zero.

(2) By eliminating from the base period whichever of the following twelve months results in the higher average base period net income—

(A) The twelve consecutive months the elimination of which produces the highest average base period net income, or

(B) The twelve months which remain after retaining in the base period the thirty-six consecutive months which produce the highest average base period net income.

(3) By computing the aggregate of the excess profits net income for each of the thirty-six months remaining in the base period.

(4) By dividing by 3 the amount ascertained under paragraph (3).

* * * *

And see Section 40.435-1 of Treasury Regulations 130 (Appendix, *infra*).

It is relevant to note exactly how taxpayer contends that its excess profits net income for the months in 1946 should be computed. Claiming that the italicized provision is applicable to it, it has taken the entire excess profits net income for the period January 1 to September, divided it by eight, and multiplied by nine. (Br. 7.) It has taken the income for the period September 21 to December 18, divided by two, and multiplied by four. It has then subtracted the loss for

December 18 to December 31, making a total claimed for the 12 months of \$226,590.62.

Taxpayer, therefore, has attributed to September two full monthly incomes, one from the preceding period, and one from the succeeding period. Similarly, it has attributed to December two monthly income, one from the preceding period, and one for the partial December period. The method used by taxpayer not only inflates the income of the partial months, but also inflates the income of the full months in the period. For the period September 21 to December 18 the total excess profits net income is \$78,512.90. Presumably some of that income was earned in the partial months of September and December. Nevertheless, by dividing the total by two and attributing the result to each of the full months as well as to each of the partial months, taxpayer arrives at total income for October and November alone of \$78,512.90. It is at least questionable whether the statute authorizes attribution of income in this way to the full months as well as to a partial month.

It is clear that taxpayer's attempt to attribute two incomes to September and to December is, as the Tax Court held (R. 37), an expansion of the twelve months of 1946 into fourteen months and is unreasonable. Taxpayer concedes (Br. 10) that its computation has led to the "unusual situation" of its having a greater credit than it would have had if its actual income for the twelve months of the calendar year 1946 had been used.

This is not only unusual; it is directly contrary to the entire policy and purpose of the statute. Taxpayer would compute its excess profits credit for the

taxable years by including in the base period year 1946 more than \$85,000 of admittedly nonexistent income. The use of the base period income as a guide to the determination of what profits are normal and what are excessive during the Korean War years then becomes meaningless. Even if the language of the statute lent support to taxpayer's contention the Tax Court could properly refuse to apply it to the facts of this case where the result is so absurd.

II

The Language Of Section 435(d) Of The Internal Revenue Code Of 1939 Does Not Warrant The Construction, For Which Taxpayer Contends, And Which Would Result In The Use Of An Exaggerated And Grossly Artificial Income For The Base Period Year 1946

Taxpayer's books were closed only once during the entire year 1946; they were not closed to reflect income for any of the fractional periods. They showed a profit of \$139,791.09, which, minus a statutory loss adjustment of \$3.33, or \$139,878.76, was determined by the Commissioner to be taxpayer's excess profits net income for the twelve months of 1946. (R. 33-34.) Again, the total excess profits net income reported by and for taxpayer on the three separate returns, comprehending its 1946 income—(by reason of inclusion of the period between September 21 and December 18 in Kaiser's consolidated return) did not differ materially from the aggregate profit shown on its books for the calendar year and which formed the basis of the Commissioner's determination. Thus taxpayer's excess profits net income for the three periods indicated was as follows (R. 34):

January 1 to September 20, 1946.....	\$68,174.60
September 21 to December 18, 1946.....	78,512.90
(Included in Kaiser's consolidated return)	
December 19 to December 31, 1946.....	(7,131.61)

Section 435(d) (1) for the purpose of ascertaining the average base period net income requires that the excess profits net income for each month in the base period be computed. The purpose of this provision is, among others, to afford the facts needed for applying the formula contained in Section 435(d) (2). The latter authorizes the elimination of those twelve consecutive months from the forty-eight month base period, which will leave the thirty-six months producing the highest average base period net income. The accomplishment of this computation often may require elimination of part of a given year, i.e., some months of a year included in the base period. Hence, it becomes necessary to ascertain the net income for each month in the base period.²

In other words, the primary purpose of Section 435(d) was to state a formula which would enable the taxpayer to select as its base period the thirty-six months of most favorable income. On the other hand, Congress showed no intention of exaggerating the true and actual income of the base period or to expand any year into fourteen months or to count the income of the same month twice. Had such an extraordinary intention on the part of the legislature existed, cer-

² For illustrative computations, see Prentice-Hall, Federal Excess Profits Tax (under Sections 430-474 of the Internal Revenue Code of 1939) (1954), pars. 45,439 to 45,441, pp. 45,445-45,450.

tainly the Committee Reports would have expressed it. But they afford no such indication whatsoever. The reflection of actual income is what Congress sought. Indeed, it was carefully provided that where for any month included in the base period a taxpayer was during no part of that month in existence, the excess profits net income for that month should be zero. For example, a taxpayer which had not been in existence during one or more of the base period years might, nevertheless, find advantageous the use of the excess proceeds credit based on income by reason of the provision for capital additions in the base period. Section 435(f).

Again, as pointed out by the Tax Court (R. 36), a taxpayer might be in existence for only a part of the beginning month of one of its taxable years and Section 435(d)(1) would afford some slight relief in such a situation. But there is no occasion here to compute this taxpayer's excess profits income for any month in 1946 during a part of which it was in existence and during a part of which it was not in existence, since there was no such month. This taxpayer was in existence both before January 1, 1946, and after December 31, 1949; both during and after each short tax period in the calendar year 1946 and during all of every one of the twelve months in the calendar year 1946.

In any event the essential purpose of the entire computation is to find the actual normal income of the business during the base years so as to compare it with its income during the excess profits tax years. But the duplication of years and of months in the base period, for which taxpayer contends, contravenes

this plain Congressional intent of computing the actual and normal income of the base period years. Thus, all agree here that the true income of taxpayer for 1946 was approximately \$140,000; Congress certainly never intended the language upon which taxpayer relies to warrant it in using the entirely fictitious income of \$226,000, an increase of approximately \$86,000 or about sixty per cent over the actual base period income for 1946. The Tax Court surely was correct in refusing to sanction such an extraordinary contention. (R. 37.)

In these circumstances the classic statement of Mr. Justice Holmes, speaking for the First Circuit in *Johnson v. United States*, 163 Fed. 30, 32, is pertinent:

The Legislature has the power to decide what the policy of the law shall be, and if it has intimated its will, however indirectly, that will should be recognized and obeyed. The major premise of the conclusion expressed in a statute, the change of policy that induces the enactment, may not be set out in terms, but it is not an adequate discharge of duty for courts to say: We see what you are driving at, but you have not said it, and therefore we shall go on as before.

Equally apt here are two quotations from Judge Learned Hand, who said, in *Federal Deposit Corp. v. Tremaine*, 133 F. 2d 827, 830 (C.A. 2d):

There is no surer guide in the interpretation of a statute than its purpose when that is sufficiently disclosed; nor any surer mark of oversolicitude for the letter than to wince at carrying out that purpose because the words used do not formally quite match with it.

and, in *Cabell v. Markham*, 148 F. 2d 737, 739 (C.A. 2d), affirmed, 326 U.S. 404:

Of course it is true that the words used, even in their literal sense, are the primary, and ordinarily the most reliable, source of interpreting the meaning of any writing: be it a statute, a contract, or anything else. But it is one of the surest indexes of a mature and developed jurisprudence not to make a fortress out of the dictionary; but to remember that statutes always have some purpose or object to accomplish, whose sympathetic and imaginative discovery is the surest guide to their meaning.

The rules enunciated have often been confirmed by the decisions of the Supreme Court, e.g., *Holy Trinity Church v. United States*, 143 U.S. 457, and *United States v. Amer. Trucking Ass'ns.*, 310 U.S. 534. The construction here sought is in harmony with the scheme of the statute in establishing the excess profits credit and must be read as part of all the provisions establishing the excess profits credit and in the light of the Congressional purpose in establishing the excess profits credit and its place in the consistent plan of the excess profits tax.³

Although under the terms of Section 435(d) the excess profits net income is to be determined for each month,²⁰ that a taxpayer may exclude its poorest con-

³ On the other hand in *Crooks v. Harrelson*, 282 U.S. 55, and *Lewyt Corp. v. Commissioner*, 349 U.S. 237, the pattern of the statutes involved was different and did not call for the Court looking beyond the literal words of a single phrase to the purpose of the Act and the scheme of the tax as a whole.

secutive twelve months or include its best consecutive thirty-six months, the starting point is the base period year, and the conclusion is a figure reflecting twelve months' income. That Congress was thinking in terms of years is indicated by its explanation of the proviso that "in no case shall the excess profits net income for any month be less than zero" as being a provision for "Counting deficit years as zero years." S. Rep. No. 2679, 81st Cong., 2d Sess., p. 6 (1951-1 Cum. Bull. 240, 243). From the excess profits net income of each taxable year is to be computed the excess profits net income for each month in the base period.

Taxpayer would go further, however, to say that the income should be computed for "each fraction of a month". (Br. 13.) The language of the section, however, does not so provide, and its intent prohibits such an interpolation. The sentence in question refers only to months and makes no provision whatever for computation of the income of partial months falling within the taxable year, with the sole exception of the case of a taxpayer beginning its existence during a month.

The language is plain. The excess profits net income for "any month" during any part "of which" the taxpayer was in existence shall be the excess profits net income for "the taxable year" in which "such month" falls divided by the number of full calendar months in "such year," but in no case shall the excess profits net income for "any month" be less than zero. The statute is drafted in terms of months, not of fractional months.

The only reference to a part of a month is in the phrase, "during any part of which the taxpayer was

in existence.” As the Tax Court points out (R. 36), this phrase is intended to take care of the situation where the taxpayer comes into existence during the beginning month of the taxable year. If the taxpayer is not in existence, the following sentence takes care of that situation; if the taxpayer is in existence for the entire month, this language is unnecessary. This taxpayer was in existence during all the months of the base period years.

The language of the sentence, then, with that limited exception, is in terms of full months, rather than partial months, in the taxable years. Furthermore, in its reference to “the taxable year” and “such year,” it is in terms of “any month” falling in only one taxable year.

It is submitted that the Tax Court correctly held that there is no authority for any such unreasonable computation as that for which taxpayer contends.

III

Alternatively, If This Court Disagrees With The Tax Court, The Case Should Be Remanded For Computation Of The Excess Profits Credit By The Method Proposed In The Amended Answer

It is our view that the decision below is correct. This Point III is to be considered only if this Court disagrees with the decision of the Tax Court.

By an amended answer (R. 21-23) in the Tax Court the Commissioner contended in the alternative that under as literal a reading of the statute as taxpayer urges, there would be increased deficiencies due. As presented to the Tax Court, the argument is that there were but two taxable years in 1946 during

which taxpayer had a separate existence. These would be the period prior to its affiliation and the period subsequent thereto. During the period that taxpayer was part of the consolidated group it had, for tax purposes, no separate existence of its own.

All that occurred was that during that period, its earnings became part of the earnings of its parent, who reported such earnings in its taxable and fiscal year ended June 30, 1947. But under Section 48(a) of the Internal Revenue Code of 1939, a fractional part of a year is a "Taxable year" only if a return is made for such period. Here, no return was filed either by taxpayer or by its parent for the fractional part of the year 1946. Accordingly, taxpayer had—taxwise—no existence for that period.

Section 435(d)(1) specifies that—

The excess profits net income for any month during no part of which the taxpayer was in existence shall be zero.

Applying this sentence here, taxpayer's excess profits net income for 1946 would be reduced below that of 1947, and the twelve months of the latter year would be substituted for those of 1946 to make up the thirty-six months of the base period years. Taxpayer's excess profits credit would be reduced, and the increased deficiencies claimed in the amended answer should be sustained.

The Tax Court, not agreeing to the method of statutory construction contended for by taxpayer and approving the Commissioner's determination necessarily rejected the Commissioner's alternative computation. (R. 37.) If this Court should disagree with

the Tax Court we respectfully urge that the case be remanded for computation of the excess profits credit by the method proposed in the amended answer.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

CHARLES K. RICE,
Assistant Attorney General.

LEE A. JACKSON,
I. HENRY KUTZ,
DAVID O. WALTER,
Attorneys,
Department of Justice,
Washington 25, D. C.

April, 1958.

APPENDIX

Internal Revenue Code of 1939:

SEC. 434 [as added by Sec. 101, Excess Profits Tax Act of 1950, c. 1199, 64th Stat. 1137].
EXCESS PROFITS CREDIT—ALLOWANCE.

(a) *Domestic Corporations.*—In the case of a domestic corporation, the excess profits credit for any taxable year shall be an amount computed under section 435 or section 436, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed.

* * * *

(26 U.S.C. 1952 ed., Sec. 434.)

SEC. 435 [as added by Sec. 101, Excess Profits Tax Act of 1950, *supra*]. EXCESS PROFITS CREDIT—BASED ON INCOME.

(a) [as amended by Sec. 602, Revenue Act of 1951, c. 521, 65 Stat. 452] *Amount of Excess Profits Credit.*—The excess profits credit for any taxable year, computed under this section shall be—

(1) *Domestic corporations.*—In the case of a domestic corporation the sum of—

(A) 83 per centum of the average base period net income.

(B) if the average base period net income of the taxpayer is the amount determined under subsection (d) of this section or under section 442, 12 per centum of the amount of the base period capital addition, computed under subsection (f), and

(C) 12 per centum of the net capital addition (as defined in subsection (g)(1)) for the taxable year,
minus 12 per centum of the net capital reduction (as defined in subsection (g)(2)) for the taxable year.

* * * *

(b) *Base Period*.—As used in this subchapter the term “base period” means the period beginning January 1, 1946, and ending December 31, 1949, except that in the case of a taxpayer whose first taxable year under this subchapter was preceded by a taxable year which ended after December 31, 1949, and before April 1, 1950, and which began before January 1, 1950, the term “base period” means the period of 48 consecutive months ending with the close of such preceding taxable year.

* * * *

(d) *Average Base Period Net Income—General Average*.—The average base period net income determined under this subsection shall be determined as follows:

(1) By computing the excess profits net income for each month in the base period. The excess profits net income for any month during any part of which the taxpayer was in existence shall be the excess profits net income for the taxable year in which such month falls divided by the number of full calendar months in such year, but in no case shall the excess profits net income for any month be less than zero. The excess profits net income for any month during no part of which the taxpayer was in existence shall be zero.

(2) By eliminating from the base period whichever of the following twelve months results in the higher average base period net income—

(A) The twelve consecutive months the elimination of which produces the highest average base period net income, or

(B) The twelve months which remain after retaining in the base period the thirty-six consecutive months which produce the highest average base period net income.

(3) By computing the aggregate of the excess profits net income for each of the thirty-six months remaining in the base period.

(4) By dividing by 3 the amount ascertained under paragraph (3).

* * * *

(26 U.S.C. 1952 ed., Sec. 435.)

Treasury Regulations 130, as promulgated under the Internal Revenue Code of 1939:

Sec. 40.435-1. *Excess profits credit based on income—Determination of average base period net income—*(a) *Introductory.* In order for a corporation to determine for any particular taxable year the amount of its excess profits credit based on income, it is necessary first to compute the amount of the average base period net income, * * *

(b) *Base period.* The term “base period” means the period beginning January 1, 1946, and ending December 31, 1949, * * *

* * * *

(d) *Computation under general average method.* The following steps are required for the computation of the average base period net income under the general average method:

(1) The excess profits net income is determined for each month during which the taxpayer was in existence during the base period. This amount is determined for any month during any part of which the taxpayer was in existence by dividing the excess profits net income (computed in accordance with the provisions of section 433(b)) for the taxable year in which such month falls by the number of full calendar months in such taxable year. In no case shall the excess profits net income for any month be less than zero. The excess profits net income for any month during no part of which the taxpayer was in existence shall be zero.

(2) The 36 months which produce the highest aggregate excess profits net income are selected under either of two methods; (i) the 12 consecutive months having the lowest aggregate excess profits net income may be eliminated; or (ii) the 36 consecutive months having the highest aggregate excess profits net income may be retained.

(3) The excess profits net income for each of the 36 months selected under (2) is aggregated.

(4) The aggregate amount computed under (3) is divided by 3.

